

**BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON DC 20268-0001**

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OFFICE OF THE SECRETARY

POSTAL RATE AND FEE CHANGES, 2000

) Docket No. R2000-1
)

**REPLY BRIEF
OF
MAIL ORDER ASSOCIATION OF AMERICA**

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**BEFORE THE UNITED STATES
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I. Bound Printed Matter.

A. The Initial Brief Of The Association of American Publishers Distorts the Record, And Reaches An Illogical Conclusion.

USPS witness Carl G. Degen filed rebuttal testimony that systematically dismantles witness Siwek's claim that the BMP Mail Characteristics Survey does not provide a reliable basis for the establishment of the proposed destination discounts. Tr. 38/17340ff. AAP's Initial Brief devotes three pages to witness Degen's rebuttal testimony. AAP Initial Brief at 18-21. Rather than any serious attempt to demonstrate why the analysis is faulty, however, the argument consists of partial quotations and other statements taken out of context, which blatantly distort witness Degen's testimony. A couple of examples will suffice. AAP begins its discussion of witness Degen's testimony by claiming that he found that witness Siwek's criticisms "may very well be technically correct. . . ." AAP Initial Brief at 18. Witness Degen actually testified: "While witness Siwek's criticisms may very well be technically correct, as I demonstrate below, **they are absurd from a practical standpoint.**" Tr. 38/17340 (emphasis added). Similarly, AAP characterizes witness Degen as having admitted that "[b]ias does exist when strata populations are measured with error." AAP Initial Brief at 18. Wholly omitted from AAP's brief is the fact that witness Degen's testimony explains why he chose to use stratification rather than a random sample. His actual conclusion was that

MOAA has joined with the Association for Postal Commerce and the Direct Marketing Association, Inc. in a Joint Reply Brief addressing the Standard Mail A pound rates and has submitted a Reply Brief, under seal addressing the SAI study.

under BPM's volume distribution, random sampling "would require enormous resources to yield useful estimates with acceptable standard errors." Tr. 38/17342. He concluded: "Given the distribution of BPM across offices, the gains in precision that result from stratification are large and the population measurement bias is small." *Id.* at 17342. A comparison of witness Degen's testimony, to the distorted description of that testimony found in AAP's brief, reveals that nothing has been done to impeach the validity of his well supported conclusions that witness Siwek's testimony has failed to undermine the reliability of the BPM survey.

In addition to systematically distorting the actual content of witness Degen's testimony, AAP does not address the totality of his testimony, testimony that reveals that the criticisms of witness Siwek have no basis in fact or theory. Witness Degen explains that the stratification procedure that he used "will produce large gains in precision under" the conditions which characterize BPM. The population being measured is composed of institutions varying widely in size, the variables to be measured are closely related to those institutions and a good measure of size is available for setting up the strata. Tr. 38/17341. As he concludes "the gains in precision that result from stratification are large and the population measurement bias is small." *Id.* at 17342. The conditions that make the use of a stratified sample preferable to the use of a random sample are present, as thoroughly explained in his testimony. Tr. 38/17342-47.

MOAA also invites the Commission's attention to the initial brief of the Postal Service at VII-121ff. The Postal Service's discussion shows that the criticisms made by witness Siwek have no basis, and demonstrates that the AAP brief represents a

distortion of the actual state of the record. The entirety of witness Siwek's testimony is well summed up in the Postal Service's Initial Brief. There the Postal Service observes that what irks witness Siwek is that the Postal Service did not choose "phasing" as an alternative to instituting all of the dropship discounts. The Postal Service accurately observes: "Witness Siwek's notion of phasing benefits a limited interest group at the expense of the rest of Bound Printed Matter and (non-BPM) mailers." USPS Initial Brief at VII-128.

AAP takes the position that the only dropship discount that should be approved by the Commission for Bound Printed Matter is the DBMC discount used by its members. This is based upon AAP's allegations of flaws in the study upon which the Postal Service has based dropshipping discounts. AAP Initial Brief at 16. Initially, even if AAP's position on the reliability of the Postal Service's study is accepted, *arguendo*, it is remarkable that AAP at the same time argues that over one half of the cost savings determined from the unreliable study be passed through to DBMC mailers. Why, in the face of what AAP contends to be a flawed study, there should be a 51.3 percent passthrough of allegedly flawed calculations of cost savings at the DBMC level, but none at the DSCF or DDU levels, is left unexplained. Presumably, this is because the position is unexplainable. AAP's position, if it is to be given any credence, argues that no drop ship discounts be given for entry at any level. There is no more reason to apply a flawed study to give a discount for entry at the DBMC than there is to give discounts to the DSCF and DDU levels.

B. Witness Siwek's Testimony Is Shown To Be Erroneous By Witness Degen's Testimony.

Witness Degen demonstrates that witness Siwek's criticisms do nothing to undermine the reliability of the stratified survey. Witness Siwek's criticism of the estimation of volumes by office for one stratum is demolished by Degen's explanation that had stratified sampling not been used "the result would not be usable due to the enormous standard errors from any practical sample size." Tr. 38/17340.

With respect to witness Siwek's criticisms that FY98 volumes were used to inflate sample data from FY99, witness Degen explains that complete FY99 data were not available when the testimony was prepared. Additionally, his testimony demonstrates "that their use makes little difference, as we expected." Tr. 38/17341.

Finally he explains that the "collapsing of strata 3 and 4 is a necessary and frequently used step" in the bootstrapping technique used by the Postal Service. *Id.* at 17341.

Witness Degen's testimony explains that stratification was chosen because it "will produce large gains in precision" under certain conditions. *Id.* at 17341. Those conditions are that the population consists of institutions varying widely in size, the variables to be measured are closely related to such sizes and a good measure of size is available for establishing the strata. *Id.* at 17341. The methodology was chosen because the gains in precision resulting from the use of the technique "are large" and the measurement bias "is small." *Id.* at 17342. He explains every choice that was made:

- There is a wide variation in the size of the offices accepting BPM. Of 27,500 facilities, 150 were responsible for 89 percent of BPM volumes. Only 20 facilities were responsible for 58 percent of the total, and of these 20, the largest office accepted 41.5 million pieces compared to 4.8 million pieces for the smallest of the 20 largest offices. 23,200 of the 27,500 locations were responsible for little or no presorted BPM. Tr. 38/17342.
- Office sizes were closely related to the pertinent variables i.e. the size of the mailing is the principal factor in a mailers decision of where to enter a mailing. *Id.* at 17342-43.
- The PERMIT system and the National Consolidated Trial Balance Revenues are nearly perfect measures of the size of revenues of given offices, with a correlation of .99. *Id.* at 17343.
- Because of the concentration of BPM volume in a few offices, random sampling would not produce reliable estimates. An unstratified sampling would have required "making inferences about dropshipping based on a sample that contained few, if any, dropshippers." *Id.* at 17343.
- A random sampling would have only sampled a tiny percentage of the offices that account for most BPM. As concluded by witness Degen in the absence of an unlimited budget "stratified sampling is the preferred approach." *Id.* at 17344.
- The use of stratum 3 data to impute counts for stratum 4 offices, offices that do not report in the PERMIT system, produces only insignificant potential error. This is because there are no systematic differences between the characteristics of stratum 3 and stratum 4 offices nor in the mailing characteristics of those offices. Additionally, any measurement error affects only a small fraction of presorted BPM. Even under the extreme assumption that stratum 4 offices could be plus or minus 25 percent different than stratum 3 offices there would be no "appreciable difference in the distributions. . . ." *Id.* at 17345.
- Any bias resulting from the use of FY98 data is small. The magnitude of any bias depends on the size of the differences that might exist between FY98 and 99, but it is clear that there was little change in mailer behavior. In FY98 the largest 20 offices accounted for 56.08 percent of volumes and in FY99 the same offices accounted for 56.33 percent. Further, zone distributions between the two years are nearly identical and the "meager differences in strata sizes between the two years indicate that any bias is small." *Id.* at 17346-47.
- Witness Siwek's claim that standard errors reflect unsound data does not reflect a serious weakness since the Postal Service addressed the issue

by “collapsing strata when estimating the population variance. . . .” This procedure resulted in estimates that “are larger than the true variance, thereby providing conservative estimates for the confidence intervals.” *Id.* at 17347-48.

In general summary, witness Degen’s testimony serves to thoroughly refute the accusations leveled by witness Siwek. The Postal Service acted reasonably and responsibly within the limits of a relatively small subclass of mail, with a nonuniform use of postal offices, to determine the characteristics of the subclass. Witness Siwek’s criticisms are shown to be nothing more than nit pics that do nothing to undermine the validity of the Postal Service’s approach.

C. The Postal Service’s Proposed Phasing Should Be Approved And AAP’s Self-Serving Concept Of Phasing Rejected.

AAP also contends that the dropshipping discounts for BPM should “be phased in over time, starting at the DBMC level.” AAP Initial Brief at 22. The Postal Service has, of course, proposed that the dropship discounts be “phased in over time,” i.e. the Postal Service is proposing that far less than 100 percent of the cost savings be passed through to the mailers. The “phasing” approach urged upon the Commission by AAP, however, is peculiar, i.e. its phasing would simply do away with the DSCF and DDU discounts. AAP’s approach would remove any incentive for dropshipping at the DSCF and DDU levels. That is a destructive approach which would harm not only the mailers willing to, and capable of, dropshipping into SCF and DDU levels, but also the Postal Service.

AAP’s attempt to rely upon the manner in which dropship discounts were introduced for parcel post does not help its case. The parcel post “phasing” relied upon

by AAP was because at the time the discounts were introduced in Docket No. R90-1, the Postal Service had developed cost savings only for entry at the DBMC level. It had not developed any cost savings for entry at the DSCF or DDU levels. Tr. 39/17444. Here, of course the Postal Service has introduced a cost study that supports discounts at all three levels of dropshipping entry. Further, the R90-1 proceeding, upon which witness Siwek relies, in itself serves to undermine his argument. In that same proceeding the Postal Service proposed (and the PRC approved) destination entry discounts for Third Class Bulk Rate Regular mail (now Standard Mail A) to all three levels, i.e. the DBMC, the DSCF and the DDU. The differing treatment of parcel post and Third Class mail was ascribable only to the fact that the Postal Service had developed cost savings for entry at each level for Third Class, but not for parcel post.

In sum, AAP can claim no precedent in either the Postal Service's proposals or the Commission's disposition of those proposals with respect to the institution of dropshipping discounts. Dropshipping discounts have proven to be one of the most beneficial innovations in postal ratemaking. They have saved costs for the Postal Service and permitted mailers to enjoy somewhat lower rates. Further, because as a practical matter the discounts do not capture the totality of cost differences between destination entered mail and mail that is not destination entered, the net effect is to benefit all users of the subclass, and in particular those mailers that do not participate in dropshipping discounts.

The AAP proposals are wholly without merit. The Commission should accept the Postal Service's approach to dropshipping discounts.

D. MOAA's Proposal To Increase The Discount For BPM Mail Entered At The DDU Is Necessary To Permit DDU Use And Would Improve The Postal Services Net Revenue Position.

In its testimony and Initial Brief, MOAA proposed to increase the discount for BPM mail entered at the DDU by increasing the passthrough from 45 to 50 percent of the cost savings. This would still result in a unit contribution to institutional costs in excess of the unit contribution for mail entered at either the DBMC or DSCF levels. Tr. 39/17449. Most importantly, the discount that has been proposed by the Postal Service will not be a sufficient incentive for mailers to perform dropshipping into the DDU. The proposal is, therefore, self-defeating.

The Postal Service appears to recognize that a larger DDU discount has merit, but also argues that "Mr. Prescott's proposal raises some concerns." USPS initial brief at VII-132. The Postal Service concludes that "movement toward higher passthroughs should occur in future cases" unless "appropriate mitigation of rate increases for non-dropship mailers" can be achieved. *Id.* at VII-133. MOAA's modest proposal, however, will have only the most insignificant affect upon mailers even under the assumption that the Postal Service's proposed revenue requirement for BPM is recommended by the Commission. The acceptance of the MOAA proposal would require only a 0.5 cents increase per piece in the base rate. That increase, in total, equals less than \$2.5 million.¹ Tr. 39/17454. The increased discounts would amount to only 3.4 cents per piece and 1.3 cents per pound.

Most importantly, adoption of the MOAA proposal would permit mitigation of the base rate. The net postal cost savings for mail entered at the DDU level exceed the net

cost savings from DSCF mail even under the increased DDU discount proposed by MOAA. Thus, because the increased DDU discounts would result in the entry of BPM at the DDU which would otherwise be entered at the DSCF, net revenues would be increased.

The net contribution made by BPM pieces entered at the DDU level, under MOAA's proposed DDU discount, would exceed the contribution that would be made if the pieces were entered at the SCF under the Postal Service's proposed DSCF discounts. The Postal Service's calculations are based upon the assumption that 35.6 million pieces will be entered at the DDU level. Tr. 39/17457. Because the DDU discount is inadequate to cover mailers' out-of-pocket costs to ship to over 25,000 DDUs, however, much of that projected volume will not materialize. Instead, it will be entered at the DSCF resulting in lower net revenues than estimated by the Postal Service. The Postal Service's net revenue loss for each BPM piece that shifted from DDU to DSCF entry would be 6.4 cents (the net difference between the increased revenue and the decreased cost savings at the DSCF level).²

In general summary, as stated in MOAA's Initial Brief, we do not quarrel with the decision of the Postal Service to phase in dropshipping discounts over time in order to permit development of more accurate cost data. At the same time, it is counterproductive to set a discount for DDU entry that will preclude its use by mailers. At the discount level proposed by MOAA, DDU entry will become possible i.e. it will more nearly equal mailer's out-of-pocket costs for entering into BPM at over 25,000

¹ 494 million pieces x 0.5 cents. Tr. 17457.

² Postal Service cost savings for DDU entry exceed savings for DSCF entry by 18.7 cents per piece. Subtracting MOAA's proposed discounts for DDU entry of 12.3 cents per piece results in a net revenue gain of 6.4 cents per piece. Tr. 39/17455-58.

DDU's. Increasing the DDU discount in the amount proposed by MOAA will improve the net revenue position for the entire BPM subclass.

II. Ramsey Pricing.

A. The Greeting Card Association And Hallmark Cards, Inc. Argue For An Approach To Ramsey Pricing Which Has Been Followed By The Postal Service.

In their Initial Joint Brief, the Greeting Card Association (GCA) and Hallmark Cards, Inc. expend a considerable amount of energy inveighing against the use of Ramsey pricing. Initial Joint Brief at 16-24. GCA is arguing for a result which, unfortunately, has already been achieved. USPS pricing witness Virginia J. Mayes, USPS-T-32, testified that: "Movement toward or away from Ramsey prices was considered in the development of the rate level proposals in this case but did not significantly affect conclusions." *Id.* at 19.

Despite this straightforward statement, GCA claims that witness Mayes testimony "fully reflects relative demand. . . ." CGA Initial Joint Brief at 16. The cited support for this clearly erroneous statement is to USPS-T-32 at 19 and Tr. 11/4252. Why GCA considers witness Mayes' testimony that Ramsey prices "did not significantly affect conclusions" as support for the claims made in its brief is mysterious. The reference to the transcript is equally mysterious. There witness Mayes testified:

"The elasticities *could* have been used in a more explicit manner to develop rate levels more consistent with a Ramsey model, such as presented by witness Bernstein, but I did not do so. Joint consideration of all of the pricing criteria led to a set of proposed rate levels that depart from the set of Ramsey prices presented by witness Bernstein." Tr. 11/4252-53. (emphasis in original).

GCA also makes the claim that witness Mayes “disclaims reliance on USPS witness Bernstein’s Ramsey prices, but her recommendations are not very different than his.” GCA Joint Initial Brief at 16. Not even clever lawyers, however, can credibly use a statement that Ramsey prices “did not significantly affect conclusions” to support a claim that “her statement fully reflects relative demand.” Further, the proposed Postal Service rates are far different than Ramsey rates. Ramsey rates for First-Class letters would be substantially higher, and Standard Mail A ECR rates nearly 50 percent lower, than the rates proposed by witness Mayes. USPS-T-41 at 10. The differences between Postal Service proposed and Ramsey rates for many other classes and subclasses are equally substantial. In sum, GCA’s claim that witness Mayes “recommendations are not very different from” witness Bernstein’s Ramsey rates is wholly at odds with the facts. GCA Initial Joint Brief at 16.

In summary, many of GCA’s arguments are advanced against an alleged use of Ramsey rates that never took place. As explained in MOAA’s initial brief, the USPS pricing witness, witness Mayes, recognized that there could be no mechanistic approach in the use (or indeed, unfortunately, even much use) of Ramsey pricing. Witness Bernstein also clearly recognized that the establishment of postal rates requires “a far more complex set of considerations in determining postal rates and the rate-making criteria appear to require them to examine concerns beyond economic efficiency.” USPS-T-41 at 108. The entire predicate of the GCA’s brief is an argument against a use of Ramsey pricing that was never advocated and never put into practice.

B. GCA's Criticisms Of Witness Bernstein's Calculation of Ramsey Prices Are Without Substance.

In addition to arguing that Ramsey pricing was used in a way that it clearly was not, GCA also argues that witness Bernstein's calculations are faulty. The criticisms are without substance.

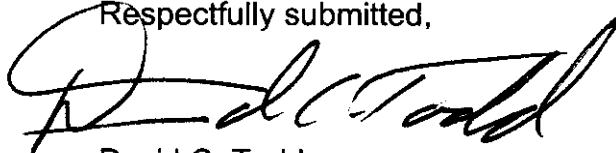
- Contrary to GCA's claim (GCA Joint Brief at 19) witness Bernstein did have adequate marginal cost data. As he testified, "marginal cost is equal to volume variable cost per piece. . . ." USPS-T-41 at 24. The criticism that he has failed to use the marginal cost for the period when the rates should be charged is nothing more than a quibble. The rates presented in witness Bernstein's testimony were for the period of October 1, 2000 through September 30, 2001, i.e. the test year used for all elements of this proceeding. GCA does not explain why this serves to impeach the accuracy of witness Bernstein's testimony. (Tr. 6/2202).
- GCA also argues that witness Bernstein's use of constant elasticities "is wrong in principal." GCA brief at 21. Witness Bernstein's actual testimony is that he used the elasticity estimates of USPS witnesses Thress and Musgrave. He did this because "constant elasticity demand specification has an excellent record of explaining the response of mail volumes to changes in postal rates." Tr. 6/2203.
- GCA accuses witness Bernstein of failing to consider "unfairness." This of course has nothing to do with Ramsey pricing but rather the fact, acknowledged by witness Bernstein, that setting rates cannot be based strictly upon a Ramsey formula, as discussed above.
- Similarly, GCA's concern about "captive trade" does not address the accuracy of Ramsey pricing, but rather the fact that Ramsey pricing alone does not encompass the more extensive criteria set forth in the Act. Again, witness Bernstein forthrightly acknowledged that both the Postal Service and the Postal Rate Commission must apply "a far more complex set of considerations in determining postal rates and the rate-making criteria appear to require them to examine concerns beyond economic efficiency." USPS-T-41 at 108.

All of the convoluted argument found at pages 20 through 22 of GCA's brief is nothing but dust in the air. Witness Bernstein used an approach that "has been

exceedingly successful at explaining this historical relation between mail volumes and base rates.” *Id.* at 2204. Contrary to GCA’s claims, witness Bernstein’s testimony does not contain “methodological errors.” Further, neither witness Bernstein nor any other witness has advocated the use of Ramsey pricing to the exclusion of the other rate making criteria of the Act.

It is, however, beyond argument that anything the Commission can do to move toward, rather than away from, more economically efficient rates, while applying the overall criteria of the Act, is a much to be desired result. GCA’s advocacy amounts to nothing more than counseling the Commission to totally ignore economic efficiency. That is bad advice. It should not be followed. Ultimately, it is impossible to avoid the economic truths established by witness Bernstein’s testimony. The Commission should give full consideration to this testimony and recognize that a move toward Ramsey prices would be beneficial, particularly for classes and subclasses of mail and other types of mail that essentially affect only business interests.³ As witness Bernstein testified “regardless of what mailing interests say, what they will do is ultimately revealed by their underlying demand for mail.” USPS-T-41 at 108.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "David C. Todd", written in a cursive style.

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³ We also invite the Commission’s attention to the excellent discussion of Ramsey prices as found in the Postal Service’s initial brief at VII-2-11. Our only regret is that so little attention was given to Ramsey pricing in the actual pricing decisions, as made clear in witness Mayes’ testimony.

CERTIFICATE OF SERVICE

I hereby certify that I have caused this Brief to be served upon all participants in this proceeding in accordance with Section 12 of the rules of practice this twenty-second day of September, 2000.

David C. Todd
